[COMMITTEE PRINT]

TAX REDUCTION PROGRAM

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INDIVIDUAL TAX REDUCTIONS

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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I. ONE-TIME INCOME TAX REFUNDS AND RELATED PAYMENTS

A. Tax Reduction Act of 1975

The Tax Reduction Act of 1975 included a refund of 1974 individual income taxes. The bill was enacted on March 29, 1975, and most of the refund checks were mailed in May and early June.

The refund equaled 10 percent of 1974 tax liability, with a maximum refund of $200 per tax return and a minimum refund of $100. The refund, however, could not exceed 1974 tax liability; that is, a taxpayer could not receive a cash refund in excess of the tax he owed. The refund was phased down from $200 to $100 as adjusted gross income (AGI) rose from $20,000 to $30,000. (For example, if an individual had AGI of $25,000, the maximum refund was $150.)

The aggregate amount of the 1975 refund was $8.4 billion. Table 1 shows the distribution of this refund by income class at 1976 income levels.

Table 1.—Distribution by Income Class of 1975 Tax Refund

[Dollars in millions; returns in thousands]

[1976 income levels]

Adjusted gross income class ($000's)	Number of returns	Amount of tax decrease	Percent of decrease
Under $5	7, 341	$588	7. 0
$5 to 10	18, 277	1, 805	21. 5
$10 to 15	15, 923	2, 109	25. 1
$15 to 20	11, 744	2, 109	25. 1
$20 to 30	9, 897	1, 348	16. 0
$30 to 50	3, 290	329	3. 9
$50 to 100	942	94	1. 1
$100 and over	212	21	. 2
Total	67, 626	$8, 403	100. 0

NOTE.—Details may not add to totals because of rounding.

In addition, the Act included a $50 payment to beneficiaries of social security, supplemental security income (SSI) and railroad retirement programs. The cost of these payments was $1.7 billoin.

B. Administration Proposal

The Administration has proposed a one-time refund of 1976 individual income taxes, which would generally be equal to $50 for each taxpayer and dependent. (For example, a family of four would generally receive $200.) In two cases, the refund could exceed 1976 income tax liability; in all other cases, the refund would be limited to the amount of 1976 income tax (as was the case in the 1975 refund).

One case in which the refund could exceed tax liability is taxpayers who claim the earned income credit. (Enacted in the Tax Reduction Act of 1975, the earned income credit equals 10 percent of the initial $4,000 of earned income and is phased out as earned income or AGI rises from $4,000 to $8,000. It is available only to taxpayers who maintain a household for their children or for an adult disabled dependent children. It is a "refundable" credit, which means it can exceed tax liability.)

If the refund were allowed to exceed tax liability only for recipients of the earned income credit, there would be a "notch" at the income level at which the earned income credit phases out. For example, a 6-person family with AGI of $7,999 would be entitled to a 10-cent earned income credit under present law, which would make them eligible for a $300 refund under the Administration proposal. (A 6-person family does not pay tax on the first $8,067 of income under existing law because of the personal exemption, the minimum standard deduction and the general tax credit.) However if the refund could exceed tax liability only for recipients of the earned income credit, a one-dollar increase in income to $8,000 would eliminate the family's earned income credit and therby reduce its refund from $300 to zero.

To prevent this "notch," the Administration proposes a second category of people for whom the refund could exceed tax liability. In general, this second category consists of people who would have been eligible for the earned income credit were it not for the income phaseout of that credit. Specifically, these are people with some earned income and a dependent child. There would still be a small number of cases in which the "notch" described above remains, but it is difficult administratively to eliminate the notch entirely and still provide the full $50 refund to recipients of the earned income credit.

The refund proposed by the administration would involve a revenue loss of $9.6 billion, all in fiscal year 1977. Table 2 shows the distribution of the refund. Seventy-four percent would go to families with incomes under $20,000, compared to 79 percent in 1975.

The Administration also proposes a $50 payment to social security, SSI, and railroad retirement beneficiaries identical to the one enacted in 1975. This would require outlays of $1.8 billion, all in fiscal year 1977.

Table 2.—Distribution by Income Class of the Administration's $50 Per Capita Tax Refund

Adjusted gross income class ($000)	Number of returns (millions)	Amount of tax decrease (thousands)	Percent of tax decrease
Under $5	9, 163	$981 [1]	10. 2
$5 to 10	19, 500	2, 004	20. 9
$10 to 15	16, 080	2, 230	23. 2
$15 to 20	11, 782	1, 907	19. 9
$20 to 30	9, 910	1, 699	17. 7
$30 to 50	3, 298	567	5. 9
$50 to 100	947	169	1. 8
$100 and over	216	36	0. 4
Total	70, 895	$9, 594	100. 0

[1] Includes $300,000,000 for people who are nonfilers, which is not included in the Treasury tax model.

Note.—Details may not add to totals because of rounding.

C. Staff Analysis

Effect on Consumer Spending

The main issue concerning the proposed refund is the extent to which people will spend it to purchase consumer goods and services. In testimony before the committee and in public discussion, economists and other experts have expressed widely divergent views on this question: some think the refund will be treated as ordinary income and spent, while others think it will be treated as an increase in wealth and largely saved. The staff does not have a firm opinion on how much of the refund will be spent, although there is some evidence that consumers will spend at least some of it.

Economists have done several studies of cases when people have received unexpected lump-sum payments, and the authors have generally concluded that, when the payment is small relative to annual income, it is treated as any other source of income and spent after a period of time. These studies, however, are based on payments made in the 1950's and may not be relevant to the current situation.

A crude way to analyze the effect of the 1975 refund on consumer spending is to examine the behavior of consumers after the 1975 refund. In the five quarters preceding the receipt of the refund consumers saved an average of 7.6 percent of their after-tax income. In the second quarter of 1975, when the refund was paid, this saving rate rose to 9.6 percent, indicating that people initially saved much of their refunds. The increased saving was reflected in a sharp increase in deposits in checking accounts. The high savings rate in the second quarter, however, does not mean that all of the refund was saved. Assuming a savings rate on other income of 7.6 percent, the overall savings rate would have been 10.4 percent in the second quarter had all of the refund been saved. The actual savings rate of 9.6 percent, therefore, suggests that as much as one-third of the refund may have been spent in the second quarter. Probably more of it was spent in the third and fourth quarters, but it is hard to draw any firm conclusions from the data. (The savings rates were 7.4 and 7.5 percent, respectively, in the third and fourth quarters of 1975, or slightly below normal.)

Employment Impact of Refund

The economic impact of the refund depends on the extent to which it increases consumer spending. Any increase in consumer spending will initially reduce existing inventories but eventually will stimulate increased production, which will lead to increased employment. The people who receive the increased income as a result of the increase in production will spend some of their additional income. This spending will lead to a further increase in income and employment—the so-called "multiplier effect."

A one-time refund will only have a temporary effect in stimulating the economy. After the refund has been spent and the multiplier effects have worked themselves out, the economy will return to the same path on which it would have been without the refund.

Monetary Effects of the Refund

Depending on the decisions of the Federal Reserve System, the refund may raise interest rates temporarily. Many people will initially deposit their refund checks in the bank, as was done after the 1975 refund. Unless the Fed supplies enough bank reserves to enable banks to meet the increased reserve requirements brought on by this increase in deposits, short-term interest rates will rise. Subsequently, as people take the money out of the bank to spend it, use it to repay debts or use it to buy some other asset, interest rates will decline again approximately to their former level.

This was the pattern of short-term interest rates after the 1975 refund. The Treasury bill rate rose from 5.3 percent in May 1975 to 6.5 percent in August and subsequently declined below its earlier level. This pattern of interest rates was an unfortunate effect of the 1975 refund, but Chairman Burns has indicated in testimony before the House Banking Committee that the Federal Reserve intends to supply enough reserves to the banking system to accommodate the temporarily increased demand for money resulting from the refund, in which case the refund should not cause a rise in interest rates.

It is sometimes alleged that the refund, by increasing the Federal deficit, will cause interest rates to rise because the Government

borrowing will reduce the availability of funds for private borrowing. As long as the economy is operating well below its potential output, however, this should not be a problem. While the increased Federal borrowing as a result of the refund will increase the demand for funds in the credit market, the refund will lead to an exactly offsetting increase in the supply of funds. First, part of the refund itself will be saved, thereby supplying funds to the credit market. Second, to the extent the refund is spent by consumers, it will lead to increased income for others; and there will be both additional taxes and additional saving out of this additional income. This will be sufficient to finance the entire amount of the additional Federal Government borrowing resulting from the refund.

Administrative Considerations

From an administrative standpoint, in order to insure that the refunds are distributed as quickly and widely as possible, the main consideration is that a family's refund should be based on data that is readily available to the Internal Revenue Service from tax returns. When the IRS receives an individual tax return, it transfers certain information from the return onto a computer tape called the "Individual Master File." The processing of a tax refund is made considerably easier if the formula under which the refund is computed is based only on data available from this Master File.

An alternative way to administer the refund would be to allow individuals to file new tax forms in order to claim their tax refund. This would involve considerable paperwork in order to distribute a relatively small amount of money, and since the IRS cannot really audit these tax forms, there is much potential for abuse. Also, many people eligible for the refund may not file the appropriate forms, so that coverage may not be any more universal under this approach than under the administration's approach.

Coverage and Double Payments

Under the administration's proposal, there will be a number of people who get no refund or who do not get the full $50 per capita. These are people who do not have tax liability large enough to utilize the full $50 per capita refund, who do not receive Social Security, SSI or Railroad Retirement, who do not claim the earned income credit and who do not have either earned income or dependent children.

A second issue is that some people will get more than one $50 payment. These cases involving double payments would include (1) social security, SSI or railroad retirement beneficiaries who also are eligible for the $50 tax refund and (2) dependents who themselves are eligible for the refund because they pay income tax and who also generate a $50 refund for their parents. The Administration estimates that 8 million people are excluded from their refund proposal, and their proposal provides refunds with respect to about 228 million people. Since the population is about 216 million, the Administration estimate implies that there would be about 20 million people receiving double payments.

There are several ways to broaden coverage of the refund. The committee could make $50 payments to identifiable groups who are likely not to receive either the tax refund or the social security payment. Some of these alternatives are discussed below under "Alterna-

tive Proposals." The problem with this approach is that it tends to increase the number of double payments.

The only way to eliminate double payments would be to go to a system under which people had to file new returns to claim their refund. The administrative problems with this approach seem greater than appears warranted by the double-payment problem. Eliminating the payment to social security beneficiaries would eliminate most double payments but would greatly increase the number of people who do not receive any refund or payment.

D. Alternative Proposals

Income Phaseout

One alternative to the Administration's proposal would be to phase out the $50 refund at higher income levels. Table 3 presents the revenue impact of various phaseouts. A phaseout between adjusted gross income of $25,000 and $35,000, for example, would reduce the amount of the refund by $818 million. Under this alternative, for a four-person family the refund would be $200 for income of $25,000 or less, $100 for income of $30,000 and zero for income above $35,000.

Although the Administration proposed a flat $50 per person credit with no phaseout, the staff understands that if the Committee wants to phase out the refund, the Administration may support a phaseout in a manner similar to the one described above.

Table 3.—Revenue Saving From Various Phaseouts of the President's $50 Refund Per Taxpayer and Dependent Exemption

Adjusted gross income phaseout ($000)	Reduction in size of refund (millions)	Returns denied the refund (thousands)
$15 to 20	$3, 353	15, 371
$20 to 25	1, 832	7, 734
$20 to 30	1, 425	4, 461
$25 to 30	1, 017	4, 461
$25 to 35	818	2, 831
$30 to 35	618	2, 831
$30 to 40	516	1, 985

Table 4.—The Administration's $50 Per Capita Refund With Several Phaseouts

[Revenue in millions of dollars]

Adjusted gross income class ($000)	Phaseout— $20,000 to $25,000	$25,000 to $30,000	$20,000 to $30,000	$25,000 to $35,000	$30,000 to $40,000	No phaseout
Under $5	$981	$981	$981	$981	$981	$981
$5 to 10	2, 004	2, 004	2, 004	2, 004	2, 004	2, 004
$10 to 15	2, 230	2, 230	2, 230	2, 230	2, 230	2, 230
$15 to 20	1, 907	1, 907	1, 907	1, 907	1, 907	1, 907
$20 to 30	639	1, 454	1, 047	1, 577	1, 699	1, 699
$30 and over				77	256	772
Total	$7, 762	$8, 577	$8, 169	$8, 776	$9, 078	$9, 594
Reduction from Administration	$1, 832	$1, 017	$1, 425	$818	$516	
Returns denied refund compared to Administration proposal (000's)	7, 734	4, 461	4, 461	2, 831	1, 985	

NOTE.—Details may not add to totals because of rounding.

Table 4 presents the distribution of various phaseout possibilities compared to the Administration's proposal. The phaseout between \$25,000 and \$35,000 would reduce the refund by \$205 million for people with income above \$50,000 and by \$567 million for people with income between \$30,000 and \$50,000.

The revenue obtained from a phaseout could be used to increase the \$50 amount. A phaseout between \$25,000 and \$35,000 would permit an increase in the \$50 figure to \$54. (The payment to social security, SSI and railroad retirement recipients could also be increased by a like amount.) Alternatively, there could be an increase in the refund to \$57 for people with income below \$10,000, with a phasedown to \$50 at income of \$15,000 and a complete phaseout between \$25,000 and \$35,000. Under this alternative, the per capital refund would be \$57 at income of \$10,000, \$53.50 at income of \$12,500 and \$50 at income between \$15,000 and \$25,000.

Another alternative which has been proposed would phase out the refund between incomes of \$25,000 and \$30,000 and use the amount gained from that phaseout (\$1.0 billion) to increase the payment to social security, SSI and railroad retirement beneficiaries from \$50 to \$78.

Another alternative would be just to phase down the refund from \$50 to \$25 at higher income levels. Such phasedowns would reduce the size of the refund by one-half the amounts shown in table 1 for the corresponding phaseouts.

Other alternatives to a one-time refund include such permanent tax cuts as increase in the personal exemption and rate reductions.

Payment to AFDC Recipients

One group that is likely to be largely excluded from the refund under the administration's proposal is families receiving Aid to Families With Dependent Children (AFDC). Most such families did not have tax liability in 1976, and most are not legally entitled to the earned income credit or a dependency exemption for their children (an issue discussed below under "Extension of 1975–76 Individual Tax Cuts"). Providing a \$50 payment of the 11½ million beneficiaries of AFDC would involve outlays of \$600 million. Such a payment could be made to people receiving AFDC in March 1977 by the State or local governmental units who administer AFDC, and the Federal Government could immediately reimburse those governments.

Other Payments

Other groups to whom \$50 payments might be made include people receiving unemployment compensation, veterans' benefits, and Civil Service retirement benefits. (Of these, only a payment to those receiving unemployment compensation is clearly within the committee's jurisdiction.) Each of these alternatives would substantially increase the number of double, and in some cases triple, payments, since many beneficiaries under these programs would get a tax refund or a social security payment.

E. Technical Issues

There are several technical issues to be decided by the committee if it agrees to a refund of individual income taxes or payment to certain recipients:

(1) The Tax Reduction Act of 1975 required that both the tax refund and social security payment be disregarded in determining benefits under federal or federally assisted aid programs. This feature could be incorporated into a 1977 refund.

(2) The 1975 Act also extended the time period in which the IRS could make interest-free tax refunds from 45 to 60 days for the 1975 refund.

(3) Some States allow a deduction for Federal income taxes under their State income taxes, in which case the refund would automatically increase State taxes. Others may attempt to have people include the Federal refund in gross income. To prevent such a State tax increase, the committee could provide that the refund is not to be considered as income or as a reduction in Federal income taxes for State tax purposes.

(4) The refund automatically reduces the income tax collections of Guam, the Virgin Islands and American Samoa. Congress could appropriate funds to compensate these possessions. It was estimated that the Tax Reduction Act of 1975 and its extensions reduced income tax revenues of the Virgin Islands by $22.9 million in 1975 and 1976, of which $2.7 million was the 1974 refund. A bill, originating out of the Interior committees enacted in the 94th Congress, authorized $8.5 million in payments to the Virgin Islands to compensate for this revenue reduction. There could be a similar authorization for any refunds paid in 1977.

II. REVISION OF THE STANDARD DEDUCTION AND TAX TABLES

A. Present Law

Under present law, the standard deduction is 16 percent of adjusted gross income, but not less than a minimum standard deduction of $1,700 for single persons and $2,100 for joint returns, nor more than a maximum of $2,400 or $2,800 for single and joint returns, respectively. These levels were made permanent by the Tax Reform Act of 1976.

Under present law, there are two ways in which a taxpayer determines the amount of tax owed. A taxpayer either determines his tax from the tax bracket rate schedules by using the rate schedule and multiplying taxable income by the appropriate tax rate or the taxpayer uses tax tables to look up the dollar amount of tax. The tax tables are considerably easier for the taxpayer than the rate schedules.

The tax tables where a taxpayer looks up, rather than computes, tax liability are based on filing status (joint return, single return, etc.) and *taxable income*. A taxpayer must compute the standard deduction (or itemized deductions) and subtract the appropriate amount from adjusted gross income. Then the taxpayer must multiply $750 times the number of personal exemptions claimed and subtract the resulting amount to obtain taxable income. Most taxpayers now look up the amount of tax before credits in a tax table based on taxable income. (This table covers taxable income up to $20,000, which is used by approximately 93 percent of all taxpayers.) The taxpayer must then compute the general tax credit, which is the greater of $35 per person (no credit for the extra aged or blind exemption) or 2 percent of taxable income up to $9,000 (a maximum credit of $180).[1] The taxpayer must then subtract this credit from the tax determined by the tables to obtain the tax after credits. If there are additional credits (such as the credit for the elderly or child care credit), they too much be subtracted.

B. Administration Proposal—Standard Deduction Increase

Initially, the Administration proposed a flat standard deduction of $2,400 for single persons and $2,800 for married couples (the maximum standard deductions under present law). These amounts would increase the "marriage penalty" (in this case the loss of the minimum standard deduction when two single persons get married) from the $1,300 under present law to $2,000. To alleviate this problem, the staff understands that the Administration may recommend a flat

[1] This credit is temporary and was extended only through 1977 by the Tax Reform Act of 1976. See the discussion in section III below on extension of 1975–76 tax cuts.

standard deduction of $2,200 for single persons ($200 less than the current maximum standard deduction for single persons) and $3,000 for joint returns. This would increase the marriage penalty only to $1,400 for people using the minimum standard deduction and reduce it in many other cases.

As shown in table 5 below, this increase in the standard deduction would reduce revenue by approximately $4 billion on a full-year basis, 88 percent of which would go to taxpayers with incomes under $15,000 and 96 percent to taxpayers with incomes under $20,000. As table 5 indicates, a relatively small number of single returns (2.1 million), which previously claimed the $2,400 maximum standard deduction, would have a slight tax increase (which would average about $52). This compares to 44.6 million returns with a tax decrease (which would average about $90).

Table 5.—Impact of the Administration's Flat Standard Deduction of $2,200 for Single Persons and Heads of Household and $3,000 for Married Couples [1]

[1976 Income level [5]]

Adjusted gross income class ($000)	Net decrease in revenue (millions)	Percentage distribution	Cumulative percentage distribution	Returns with tax decrease (thousands)	Returns with tax increase (thousands)	Tax increase (millions)	Average tax increase (actual)
Under $5	$477	11.8	11.8	7,200			
$5 to 10	1,715	42.5	54.3	16,842			
$10 to 15	1,355	33.6	87.9	11,557	596	$15	$25.17
$15 to 20	322	8.0	95.9	5,602	1,094	64	58.50
$20 and over	163	4.0	100.0	3,387	372	29	77.96
Total	$4,032	100.0		44,588	2,063	108	52.35

[1] This proposal would cause an estimated 5.2 million returns to switch to the standard deduction.

Congress has used the minimum standard deduction (which under the Administration's proposal would become the standard deduction for everyone) to establish, in conjunction with other provisions, the tax-free income level approximating the poverty level. This policy started with the Revenue Act of 1964.

The extent to which the higher standard deduction determines a tax-free income level and how that tax-free level compares to the projected poverty levels is shown in table 6 below. For example, under present law, the tax-free income level for a single person is $2,700. With the proposed flat standard deduction of $2,200, the tax-free income level would be $3,200 in 1977. (The $3,200 is the sum of the $2,200 standard deduction, the $750 personal exemption, and $250 of income, the tax on which is offset by the $35 per capita tax credit.) This compares with the projected poverty levels of approximately $3,100 in 1977 and $3,400 in 1979. Table 6 shows a similar comparison for married couples of various sizes.

The changes in the standard deduction would be reflected in reducing withholding beginning May 1, 1977. The withholding change is intended to be at the proper annual rate rather than an accelerated rate to reflect the entire year's liability change in only eight months of withholding. The reduction in withholding would apply to both standard deductors and itemizers, for whom the reduction in withholding would generally represent smaller refunds but in some cases would require larger final payments. It is estimated that the withholding changes would reduce receipts by $1.5 billion in fiscal year 1977, $5.6 billion in fiscal year 1978 and $4.4 billion in fiscal year 1979. The large revenue loss in fiscal year 1978 would be due to thesubstantial refunds resulting from the late start of reduced withholdings in 1977.

Table 6.—Tax-Free Levels Under Present Law and Proposed Flat Standard Deduction of $2,200 Single, $3,000 Joint Compared to Projected Poverty Levels

	Tax-free levels		Projected poverty levels [1]	
	1976 law	Proposed for 1977 and thereafter [2]	1977	1979
Single person	$2,700	$3,200	$3,107	$3,439
Couple without dependents	4,100	5,000	4,018	4,448
Family of 4	6,100	7,000	6,110	6,763

[1] Applicable to nonfarm families. Projections assume consumer price indices of 179.11 in 1977 and 198.26 in 1979.

[2] Assumes extension of the $35 per capita tax credit.

Source: Treasury Department.

C. Administration Proposal—Tax Forms and Tax Tables

Standard Deductors

The Administration proposal for a flat standard deduction would simplify the existing tax forms by eliminating the current presentation of the standard deduction on the form. Currently, this requires 5 numbers relating to the standard deduction just for married and single taxpayers (two minimums, a percentage of income, and two maximums) on both the form 1040 and the 1040A short form. In addition, the Administration proposal would eliminate the tax tables based on taxable income that were adopted in the Tax Reform Act of 1976 and would return to the prior system of tax tables based on adjusted gross income and the number of exemptions. For those using the revised tax tables, this change would make it unnecessary to compute taxable income and the general tax credit. These computations now require—

(1) subtracting from the taxpayer's AGI the standard deduction and personal exemptions ($750 times his number of exemptions) to determine taxable income.

(2) using taxable income and filing status (married, single, etc.) to determine tax liability from the tax table,

(3) computing the general tax credit (the greater of $35 per capita or 2 percent of taxable income up to $9,000), and

(4) subtracting the general tax credit from the tax amount obtained from the tables.

Under the Administration's proposal, the standard deductor would simply look up his tax in the tables based on adjusted gross income and number of exemptions. This is the method that had been used prior to 1976 in the "optional" tax tables for standard deductors with incomes below $15,000.

These proposed tax tables could be made available to standard deductors, for example, with adjusted gross income below $20,000 for single returns and $40,000 for joint returns and three or fewer exemptions for single returns and nine or fewer exemptions for joint returns. (The Internal Revenue Service could be permitted to determine the exact dimensions of the tables, depending on the increase in the size of the tables relative to the additional taxpayers covered by selecting the higher amounts.)

To make it possible to use a tax table which incorporates the general tax credit, the Administration also recommends making the $35 per capita credit part of the general tax credit available for the extra exemption available to the aged and blind. This change would reduce receipts by $76 million in fiscal year 1978.

General tax credit for married couples filing separate returns.—Another simplifying change the committee may wish to consider involves married couples filing separate returns, who would be able to use the tax tables. Because of the optional feature of the general tax credit (2 percent of taxable income with a maximum of $90 for separate returns or the $35 per capita tax credit), the tax tables require two columns, one for each type of credit. This is necessary because both spouses are required to elect the same alternative. Two columns and a consistent election is not only confusing but is difficult for many taxpayers filing separate returns to comply with because they often do not know the election the other spouse has made. These problems could be avoided

if the general tax credit were limited to the $35 per capita credit and the 2 percent of taxable income credit were eliminated for married couples filing separate returns. Since most married couples who file separate returns are in fact separated, one spouse frequently is unable to claim any exemption for dependents and therefore selects the 2 percent of taxable income credit. The maximum tax increase that would result if the 2 percent credit were eliminated would be $55 (the difference between the $90 maximum on the 2 percent credit and the $35 per capita credit).

Itemizers

Under the Administration proposal, itemizers with "income" and exemptions under the maximum amounts that permit a taxpayer to use the tax tables would also use the same tax table used by the standard deductors. This would be accomplished by imposing as a floor on itemized deductions the amount of the standard deduction, which would be built into the tax tables. Itemizers would perform the following calculations:

(1) Subtract the standard deduction from their total itemized deductions to determine their itemized deductions in excess of the floor;

(2) Subtract these excess itemized deductions from their adjusted gross income to obtain their "tax table income"; and

(3) Using this income, look up their tax in the tax table based on this "tax table income" and number of exemptions. This is the same table used by standard deductors.

In this way, itemizers would receive the full benefit of their itemized deductions (since the amount of the standard deduction used as the floor under itemized deductions would be built into the tax tables) but would not have to compute and subtract their personal exemption or calculate and subtract the general tax credit. All of these computations would be built into the tax tables, just as they would be for standard deductors.

Those taxpayers ineligible for the tax tables would not use the tax tables but would use a tax rate schedule into which the standard deduction would be built as a zero bracket. For example, the current bottom bracket for joint returns to which the 14 percent rate applies is $0 to $1,000. Under the Administration proposal, the bottom bracket for joint returns would be $0 to $3,000 with a zero rate (since the proposed standard deduction is $3,000 for joint returns). The second bracket would become $3,000 to $4,000, to which the 14-percent rate would apply. Taxpayers ineligible for the tax tables would include those with too much "tax table income," too many exemptions, or who use such provisions as income averaging and the maximum tax.

In order to use this tax rate schedule with the standard deduction built in, the Administration proposes to change the definition of taxable income (in effect, increasing taxable income by the amount of the flat standard deduction).

D. Staff Analysis

The present individual income tax forms need to be simplified. The forms have become too long and too congested and are themselves a source of complexity and taxpayer confusion and error. To the

extent that the flat standard deduction will remove lines from the form, it appears to be an appropriate step. Also, the proposed increase in the standard deduction would make it worthwhile for 5.2 million taxpayers to use the standard deduction, raising from 69 to 75 percent the percentage of taxpayers using the standard deduction.

The question could be raised as to whether a tax reduction that goes only to standard deductors and provides nothing to itemizers is appropriate. (One way of avoiding this problem is discussed further below in connection with the floor on itemized deductions.)

Some tax reduction, it is argued, is needed to offset the effects of inflation in raising tax rates. Table 7 shows an estimate of the tax increase in 1976 that resulted from the 5.8 percent increase in the price level in 1976 compared to 1975. This tax increase from inflation amounted to $5.1 billion, or 3.6 percent of individual income tax liabilities.

If permanent tax changes are to be considered, the committee may want to consider other types of tax change that have been proposed, such as an increase in the personal exemption, reduction in the lower bracket tax rates or an increase in the per capita tax credit.

Table 7.—1976 Tax Increase Caused by Inflation

[Dollars in millions]

Adjusted gross income class ($000)	Present law tax	Inflation induced tax increase [1]	Percentage distribution
Under $5	$660	$166	3.2
$5 to 10	10,194	664	13.0
$10 to 15	19,971	760	14.9
$15 to 20	23,767	831	16.3
$20 to 30	33,682	1,177	23.0
$30 to 50	22,512	823	16.1
$50 to 100	16,700	514	10.0
$100 and over	13,600	179	3.5
Total	141,087	5,113	100.0

[1] Staff estimate of the excess of actual taxes in 1976 over what taxes would have been had the tax brackets, the personal exemption, and the minimum and maximum standard deduction been adjusted upward by the 5.8 percent increase in the consumer price index for 1976 over 1975.

Note.—Details may not add to totals because of rounding.

If the committee wants to provide tax relief focused on itemizers, the proposed floor on itemized deductions provides a mechanism for doing it. Tax reduction for itemizers could be provided by reducing the floor on itemized deductions by some amount, but retaining the full standard deduction in the tax tables.

The proposal to return to a tax table based on AGI and the number of exemptions rather than the present taxable income tables which require taxpayers to make several computations seems desirable given IRS experience to date with the new tables.

The Internal Revenue Service has reported that about 11.5 percent of the 1040A tax returns filed in the early weeks of the current tax

season contained errors, about twice the prior year error rate. About 2.3 percent of the returns had errors in computing the standard deduction and 4.6 percent had errors in computing the general tax credit. If these error rates are indicative of the error rate which will be experienced on all 1040As filed, about 700,000 returns will have errors in computing the standard deduction and 1.4 million returns will have errors in computing the general tax credit. [2]

Including itemizers in the tax table would simplify the tax computation for itemizers. However, placing a floor equal to the standard deduction on itemized deductions might confuse itemizers who might not understand the purpose of such a floor. This confusion might be avoided by including an explanation at that point on the form that they are not losing any itemized deductions because the amount of the standard deduction is being built into the tax tables. (This suggestion for an explanation on the form was made by the Administration.)

Under the Administration's proposal, taxable income would be redefined to be present law taxable income plus the new standard deduction, so that the standard deduction could be incorporated into the rate schedules. This change in the definition of taxable income may create problems, since there are many other provisions of the tax law which use taxable income. It may very well be that in a broad structural tax reform bill it would be appropriate to redefine taxable income and after a full examination of all the provisions in the Internal Revenue Code to which such a change would affect. However, in view of the fact that the term "taxable income" has been such a basic concept in our tax system, there have been questions raised as to whether it is appropriate in this bill to consider such a significant change in the use of this term in view of the brief period which is available with respect to this bill to fully examine the impact of such a change and guarantee that all effected provisions would be fully coordinated. If the committee is concerned about this aspect of the Administration's proposal, it could adopt all of the simplification changes involving the standard deduction as well as the tax table changes except for the change in the rate schedules and still provide substantially all of the simplification proposed by the Administration, which would simplify the tax return for approximately 95 percent of taxpayers.

The change in the definition of taxable income may also create difficulties with State income taxes which are based on the Federal definition of taxable income. These States, of which there are eight, would need to change their tax laws to conform to the new Federal definition or to adjust Federal taxable income on their forms in order to avoid a tax increase for their residents would result. In addition, changes would be required in tax laws in order to permit the Federal collection of State income taxes ("piggybacking").

If the committee wants to retain the current definition of taxable income, this could be achieved by requiring taxpayers who would not use the new tax tables to make one additional computation. This computation would require them to subtract the standard deduction floor from "tax table income." This would yield present law taxable income, at which point the taxpayer would use the present rate schedules to compute the tax.

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[2] As indicated in a letter report from the Comptroller General to the Joint Committee on Taxation (GAO Report No. GGD–77–26, February 9, 1977, p. 2).

III. EXTENSION OF 1975–76 INDIVIDUAL TAX CUTS

A. Present Law

The Tax Reform Act of 1976 extended through 1977 the temporary individual tax reductions originally enacted in 1975 and subsequently enlarged and extended through 1976. These are the general tax credit and the earned income credit. (The increases in the standard deduction enacted in 1975 and 1976 were made permanent by the 1976 Tax Reform Act.)

General tax credit.—The general tax credit equals the greater of (1) $35 per taxpayer and dependent or (2) 2 percent of the initial $9,000 of taxable income. In 1977, the revenue loss from the credit is estimated to be $10.1 billion. Extending the credit through 1978 would reduce budget receipts by $6.8 billion in fiscal year 1978 and $4.0 billion in fiscal year 1979. (The Administration proposes extending the the $35 credit to extra exemptions for age and blindness, which is assumed in the revenue estimates.)

Earned income credit.—The earned income credit equals 10 percent of the initial $4,000 of earned income. It is phased out as adjusted gross income or earned income rises from $4,000 to $8,000 and is available only to people with dependent children or with disabled adult dependent children. The credit may exceed tax liability; that is, it is a "refundable" credit, in contrast to the general tax credit which is limited to tax liability. The revenue loss from the earned income credit in 1977 is estimated to be $1.3 billion. Extending it through 1978 would have no impact on fiscal year 1978 receipts but would reduce receipts in fiscal year 1979 by $1.3 billion.

B. Staff Analysis and Alternative Proposals

The economic outlook appears to warrant extending the 1975–76 individual tax cuts through 1978. The staff understands that such an extension of the individual tax cuts is part of the Administration's program for economic recovery and that the Administration supports providing the extension through 1978 in this bill.

There has been some criticism of the general tax credit, and the committee may want to reconsider its structure when it deals with tax reform. Therefore, it may want to limit any extension of the credit to 1978. However, the 10-percent investment credit was extended to 1980 in the Tax Reform Act of 1976, and there has been some interest expressed in extending the individual tax cuts through 1980 to have all the tax cuts expire at the same time.

One problem with the general tax credit is the complexity for the taxpayer in computing a credit that equals the greater of two alternatives. Under the change in tax tables proposed by the Administration this complexity would be greatly reduced because the credit would be incorporated into tax tables for most taxpayers. Combining the general tax credit and the personal exemption into one per capita credit or into a larger exemption would be a simplification for taxpayers who are unable to use the new tables.

A second problem with the general tax credit is that in some cases it significantly increases the so-called "marriage penalty." The 2-percent variant of the credit is worth $180 for a single person with taxable income exceeding $9,000. Thus, when two such people marry each other, they have a tax increase of $180 because they lose one of their $180 credits.

The committee will probably want to reconsider the role of the earned income credit when it deals with comprehensive welfare reform. Thus, in this bill it may want to limit the extension of the earned income credit to 1978.

Earned income credit for AFDC recipients.—The earned income credit is available only to people who "maintain a household" for a child or an adult disabled dependent, and "maintaining a household" means that a person furnishes more than one-half the cost of that household. For this purpose AFDC payments are considered support provided by someone other than the parent; therefore, recipients of AFDC for whom AFDC constitutes more than one-half their income are not considered to be maintaining a household for their children and are not entitled to the earned income credit. The committee may want to modify the earned income credit to make it available to AFDC parents with earned income.

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